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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of:

Federal-State Joint Board on Universal
Service

Forward-Looking Mechanism for High
Cost Support for Non-Rural LECs

CC Docket No. 96-45

CC Docket No. 97-160

REPLY COMMENTS OF GTE SERVICE CORPORATION

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SUMMARY

Throughout this proceeding, GTE has emphasized that allowing competitive market forces to allocate universal service funding will produce more accurate and efficient results than a cost model. Until such a competitive bidding mechanism can be implemented, carrier-specific, state-approved cost models are the best method for ensuring that carriers are compensated for the full costs of providing universal service.

However, if the Commission decides to use a cost proxy model, the selected mechanism should rely heavily on user-adjustable inputs which allow the differences among and within states to be taken into account. Moreover, the Commission must ensure that those inputs have a significant effect on the results of the model, or they will not be effective in incorporating these differences. As GTE has explained in its Comments, the Hatfield Model input values were not derived using commonly accepted cost modeling and data collection practices and should not be adopted by the Commission. Further, although the Hatfield Model includes many user-adjustable inputs, the majority of these inputs have little to no effect on the results of the Model, making them useless as a basis for adjusting Model output to account for conditions in different areas.

In its Comments, GTE emphasized in its Comments, the selected cost mechanism should use economic depreciation rates and asset lives. Those commenters urging the Commission to use its current rates fail to refute the clear evidence that these rates are not the same as those used by non-regulated firms or by ILECs in their financial records. In addition, the Commission should ensure that any

local usage requirement takes into account state usage requirements and allows carriers to have pricing flexibility.

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REPLY COMMENTS OF GTE SERVICE CORPORATION

GTE Service Corporation and its affiliated domestic telephone operating companies (collectively "GTE")¹ respectfully submit their Reply Comments on the Further Notice of Proposed Rulemaking ("FNPRM") in the above-captioned proceedings.² Throughout this proceeding, GTE has continually emphasized that no model can allocate resources as efficiently as an auction mechanism. Until a competitive bidding approach can be implemented, high cost support should be based on an engineering model using carrier-specific inputs. The more actual data that are used, the more accurate the results will be, and the more likely the ultimate support levels will be "sufficient," as required by Section 254 of the Communications Act. As numerous commenters have demonstrated, the Hatfield Model is designed to

¹ GTE Alaska, Incorporated, GTE Arkansas Incorporated, GTE California Incorporated, GTE Florida Incorporated, GTE Hawaiian Telephone Company Incorporated, The Micronesian Telecommunications Corporation, GTE Midwest Incorporated, GTE North Incorporated, GTE Northwest Incorporated, GTE South Incorporated, GTE Southwest Incorporated, Contel of Minnesota, Inc., and Contel of the South, Inc.

² FCC 97-256 (rel. July 18, 1997).

understate costs and uses input values that are not even supported by the Model's own source data. That Model should therefore be rejected outright.³

I. THE HATFIELD MODEL IS RESULTS-ORIENTED AND DOES NOT REFLECT THE ACTUAL COSTS OF PROVIDING UNIVERSAL SERVICE.

As GTE explained in its comments, despite the fact that the Hatfield Model has incorporated numerous changes to its algorithms, the universal service cost estimates produced by the Model somehow remain the same. Detailed examination of the Model and its supporting sources shows that the Model developers have maintained these same bottom line costs by making unsupported changes to the Model and by "data shopping" so that sources not supporting the desired low cost results are ignored.⁴ Comments from the Model's proponents further demonstrate these problems.

For example, AT&T and MCI state that because "the frequency with which guys and anchors must be installed [on telephone poles] does not follow a formula that is systematically influenced by terrain, density, or other observable factors separately identifying these costs would add complexity without any benefit in increased accuracy."⁵ Since these parties readily admit they do not have a formula to predict the

³ In its Comments filed on October 17, GTE provided detailed recommendations for input values for a cost proxy model. Therefore, in this Reply, GTE responds to only a few issues raised by other parties.

⁴ Comments of GTE Service Corporation, CC Docket Nos. 96-45, 97-160 at 2-9 (filed Oct. 17, 1997) ("GTE Comments").

⁵ Comments of AT&T Corp. and MCI Telecommunications Corporation on Designated Input and Platform Issues, CC Docket Nos. 96-45, 97-160 at 12 (filed Oct. 17, 1997) ("AT&T/MCI Comments").

need for guys and anchors, their statement that "the Hatfield default installation cost value reflects composite labor costs that include miscellaneous equipment, including guys and anchors"⁶ is not credible.

Similarly, the claim that a \$417 default value for materials and installation for poles is "conservatively high" and "supported by outside sources"⁷ is not consistent with previous Hatfield Model versions. Hatfield Model 2.2.2 used 35 foot poles to estimate costs of \$450 each. The Hatfield Model developers realized that larger poles were necessary, so versions 3.1 and 4.0 use 40 foot poles instead. However, the Model developers assumed that the total cost for the larger pole, with the additional labor and material and guys and anchors, would be only \$417. No explanation has been given as to why using larger poles with additional materials decreases the cost per pole.

Likewise, the Hatfield proponents defend their interoffice facilities cost estimates as using "conservative platform characteristics" and affirm that "the Model allows the user to exercise significant control over this estimation algorithm by including over 60 user adjustable input values."⁸ GTE agrees that user-adjustable inputs are critical to ensuring that individual characteristics of different areas and companies are taken into account by a cost proxy model. However, in order for such inputs to be effective, the model must be designed so that the adjustable inputs affect the ultimate results. While the Hatfield Model includes numerous user-adjustable inputs, the majority of those

⁶ AT&T/MCI Comments at 11.

⁷ AT&T/MCI Comments at 11.

⁸ AT&T/MCI Comments at 21.

inputs have little to no effect on the Model's output. This is consistent with the efforts of the Model's developers to estimate low universal service costs regardless of actual costs.

The inconsistencies listed above are only a few examples of the problems affecting Hatfield Model input values. Unfortunately, data shopping and unsupported changes are pervasive in the Model. These practices, combined with the fact that most user-adjustable inputs do not have much effect on the Model's results, ensure that the Hatfield Model consistently underestimates the actual costs of providing universal service.

II. THE COMMISSION'S APPROVED DEPRECIATION RATES DO NOT REFLECT REALISTIC ECONOMIC LIVES. (Section III.C.6)

In the FNPRM, the Commission tentatively concludes that depreciation rates used in the selected mechanism should be based on the rates currently specified in the Commission's rules.⁹ As GTE explained in its Comments, the Commission's rates do not reflect actual economic lives of equipment and are not the same as those used by LEC competitors not subject to regulation.¹⁰ Several commenters in addition to GTE support the use of economic life-based depreciation rates, including the Puerto Rico Telephone Company ("PRTC")¹¹ and Bell Atlantic.¹² PRTC notes that:

⁹ FNPRM, ¶ 152.

¹⁰ GTE Comments at 38-40.

¹¹ Comments of Puerto Rico Telephone Company, CC Docket Nos. 96-45, 97-160 at 4 (filed Oct. 17, 1997) ("PRTC Comments").

[a] better approach [than that suggested by the Commission], and one that reflects actual telephone company investment decision making is to use economic depreciation lives. Given the rapid deployment of new technologies, a significant amount of telephone company plant and equipment may have shorter lives than reflected in the depreciation lives authorized by the Commission.¹³

State commissions have come to similar conclusions in examining depreciation evidence in interconnection arbitration proceedings. For example, in its Final Arbitration Order for GTE Midwest Incorporated and AT&T Communications of the Southwest, the Public Service Commission of the State of Missouri ("Missouri PSC") noted that the depreciation rates used in the past were too long.¹⁴ In order to "determine reasonable depreciation rates so that a utility will recover its TELRIC investment over the economic life of the equipment,"¹⁵ the Missouri PSC staff conducted an independent study of the depreciation rates used by "likely competitors and other companies using similar

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¹² Comments of Bell Atlantic on Inputs, Expenses, and Other Issues, CC Docket Nos. 96-45, 97-160, Attachment at 3 (filed Oct. 17, 1997) ("Bell Atlantic Comments").

¹³ PRTC Comments at 4.

¹⁴ Final Arbitration Order in the Matter of AT&T Communications of the Southwest, Inc.'s Petition for Arbitration Pursuant to Section 252(b) of the Telecommunications Act of 1996 to Establish an Interconnection Agreement Between AT&T Communications of the Southwest, Inc. and GTE Midwest Incorporated, Public Service Commission of Missouri, Case No. TO-97-63, Attachment C at 76 (issued July 31, 1997).

¹⁵ *Id.*

technologies.”¹⁶ The Commission found that GTE’s suggested depreciation rates were lower than all other companies the staff reviewed except AT&T.¹⁷

The California Public Utilities Commission (“CPUC”) has also endorsed the use of economic lives for computing depreciation. The CPUC concluded that the economic lives used by GTE and Pacific Bell for external financial reporting were forward-looking and therefore appropriate for use in cost studies. It also rejected the suggestion of AT&T and others that Commission-prescribed lives are forward-looking.¹⁸ Similarly, in Indiana, a member of the Office of Utility Consumer Council testified that he did not “consider the FCC [depreciation] information as necessarily being up to date.”¹⁹

Although some commenters defend the Commission’s depreciation rates as forward-looking, they offer no credible evidence to support this point. While the Hatfield Model proponents state that the Commission’s rates “are forward-looking and fully appropriate for use in TELRIC cost studies,”²⁰ they fail to acknowledge that several state commissions that have reviewed the matter in detail have reached the opposite conclusion. They also argue that there is no reason to shorten asset lives used to

¹⁶ *Id.* at 77.

¹⁷ The Missouri PSC noted that AT&T’s depreciation rate may have been distorted by the Lucent Technologies and NCR spin-offs. *Id.* at 79.

¹⁸ California Public Utilities Commission Decision No. 96-08-021, Docket Nos. R.93-04-003, I.93-04-002 (adopted Aug. 2, 1996) (“CPUC Comments”).

¹⁹ Testimony of Harold L. Rees, Indiana Utility Regulatory Commission, Cause No. 40734 at A60 (Sept. 11, 1997).

²⁰ AT&T/MCI Comments at 21.

compute depreciation rates "in response to speculative forecasts of possible future competitive pressures."²¹ This assertion is wrong on two counts. First, ignoring future competition is completely at odds with the Commission's forward-looking approach. Second, competition in the local market is already occurring and cannot be deemed to be "speculation." Therefore, universal service cost estimates should be based on depreciation rates used by a competitive firm, i.e. economic lives.²²

Similarly, the General Services Administration ("GSA") states that "[t]he Commission's adoption of forward-looking projection lives and future net salvage percents has been an outstanding success."²³ However, GSA's analysis fails to consider the rates of competitive firms. GSA asserts that "the latest filings by LECs subject to Commission prescription indicate that LECs have an overall reserve surplus of over \$500 million dollars [sic]."²⁴ This conclusion ignores the more realistic asset lives used by both competitive firms and by LECs for their financial records.

The reserve discussed by GSA is calculated by taking the original cost of assets and subtracting the anticipated future accruals and anticipated salvage values.

²¹ AT&T/MCI Comments at 22. Interestingly, in other areas, such as facilities sharing, Hatfield Model proponents are perfectly willing to base Model inputs on "speculations" such as "Congress and municipalities increasingly believe that structure sharing will or should become ubiquitous." *Id.* at 8.

²² GTE notes that neither AT&T nor MCI has argued that they use depreciation rates similar those prescribed by the Commission even though these companies use many of the same types of equipment as LECs.

²³ Comments on Section III-C-6 of the General Services Administration, CC Docket Nos. 96-45, 97-160 at 5 (filed Oct. 17, 1997) ("GSA Comments").

²⁴ GSA Comments at 5 (footnote omitted).

Future accruals are defined as:

$$\text{Future accruals} = (\text{remaining life} \times \text{whole life depreciation rate}).$$

The whole life depreciation rate is:

$$\text{Whole life depreciation rate} = (100\% - \text{average net salvage \%}) / \text{average life}.$$

Therefore, the reserve is:

$$\text{Reserve} = 100\% - \text{future net salvage} - \text{future accruals}.$$

GSA calculates that LECs have a \$500 million surplus using the Commission-prescribed asset lives. These asset lives are much longer than those used by telecommunications firms competing with LECs and by GTE and other regulated firms in their financial reporting. If these shorter lives are used to compute the theoretical reserve, then LECs actually have a depreciation deficit of approximately \$38.9 billion.²⁵

The Commission's current asset lives and depreciation rates were developed in order to keep telephone rates low by underestimating depreciation expense, not to determine the actual economic life of equipment. With the advent of competition and the development of a forward-looking cost mechanism, the only way to ensure that Congress's requirement that there be sufficient universal funding is met is to use economic depreciation rates and asset lives.

²⁵ See Comments of the United States Telephone Association, CC Docket Nos. 96-262, 94-1, 91-213, 96-263, Attachment 12 at 8 (filed Jan. 29, 1997).

III. THE COMMISSION'S LOCAL USAGE REQUIREMENTS SHOULD BALANCE THE NEED TO ENSURE ADEQUATE SUPPORT FOR CARRIERS WITH THE NEED FOR PRICING FLEXIBILITY. (Section IV)

In its FNPRM, the Commission seeks comment on the minimum amount of local usage that should be included in the definition of basic local service and on the amount of usage that should be assumed for purposes of the universal service cost models.²⁶ Because both state and federal regulations apply to the provision of basic local service, the Commission should consider separately the questions of the amount of local usage that should be included in the definition of basic local service and the amount of usage that should be supported by the universal service fund. As explained below, the Commission should ensure that the funding mechanism pays the costs of the basic service that ILECs are required to provide but should consider establishing a reasonable minimum level of usage to be included in the definition of local service for universal service purposes.

A. Any local usage component included in the cost model mechanism should reflect state usage requirements.

If the Commission incorporates a local usage component in the universal service calculations, GTE agrees with the CPUC and other parties who recommended that the cost model should assume, for purposes of estimating universal service costs, the number of minutes of local calling per month used by an average residential customer.²⁷

²⁶ FNPRM, ¶¶ 179-180.

²⁷ CPUC Comments at 6. See also Comments of Aliant Communications Co., CC Docket Nos. 96-45, 97-160 at 10 (filed Oct. 17, 1997) ("Aliant Comments"); Joint
(Continued...)

Most states require ILECs to provide flat-rate local service as part of their universal service obligations today, and the vast majority of local customers subscribe to these flat-rated service options. Even if the Commission were to specify some lower amount of usage in its definition, no ILEC would be able to withdraw its flat-rated offerings because of state requirements. Therefore, the selected mechanism should reflect the usage ILECs are actually obligated to provide, which under flat-rate calling options is average usage.²⁸ However, as GTE stated in its Comments, there is not yet sufficient information to determine the average local usage and detailed studies would be required.²⁹

In its comments, AirTouch suggests that including a local usage component based on current average customer usage into the cost models will somehow bias universal service support towards technologies which have low incremental usage

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Comments of BellSouth Corporation, BellSouth Telecommunications, Inc., U S WEST, Inc., and Sprint Local Telephone Companies to Further Notice of Proposed Rulemaking Sections III.C.5, 7, 8 & III.D Platform III.B.3 & III.C All Inputs and IV and V, CC Docket Nos. 96-45, 97-160 at 11 (filed Oct. 17, 1997); Comments of Ameritech Regarding Miscellaneous Aspects of Cost Model, CC Docket Nos. 96-45, 97-160 at 3 (filed Oct. 17, 1997); PRTC Comments at 7.

²⁸ The treatment of business service presents some difficulty since the models currently under consideration count all residence and business lines together and assume that their costs are the same within each area. As the CPUC suggests, it is reasonable to count all minutes for the purpose of the determining the size of network components and average per-minute costs in each area. The average amount of usage actually demanded by residential customers should then be used to apportion switch costs to basic local service and a similar measure of average usage for single line business could be used to apportion switch cost to basic local service for those customers, assuming this type of breakdown is available.

²⁹ GTE Comments at 40-41.

costs.³⁰ However, AirTouch fails to explain how or this would occur. To achieve competitive neutrality and to mimic the workings of a competitive market, the Commission should not attempt to model wireless costs or to use assumptions based on the operations of wireless carriers. Rather, it should reflect the costs of the incumbent wireline carriers as accurately as possible since wireless technology is not a substitute for wireline services in the near term.³¹

B. Carriers should be allowed to meet the minimum usage requirement using different usage/price combinations as long as the overall price of the service and minimum usage meets the affordability standard.

The FNPRM seeks comment on the amount of local usage to be included in the definition of universal service.³² As explained above, the amount of usage included in the universal service definition can be different from the usage level assumed in the cost model. The difficulty in establishing a minimum usage amount for the basic service definition is that the current ILEC service offerings include both flat-rated service and a variety of measured service options, many of which do not include any minimum usage allowance.³³ Thus, if the Commission establishes a definition which requires any minimum usage level be included in the monthly recurring rate, many current

³⁰ Comments of AirTouch Communications, Inc. on Section IV, CC Docket Nos. 96-45, 97-160 at 3-4 (filed Oct. 17, 1997) ("AirTouch Comments").

³¹ See Comments of GTE Service Corporation, CC Docket Nos. 96-45, 97-160 at 14-16 (filed Sept. 24, 1997).

³² FNPRM, ¶ 179.

³³ GTE Response to Universal Service Data Request 4, CC Docket No. 96-45, DA 97-
(Continued...)

subscribers will find that the measured service package they purchase today does not meet this definition. For example, the CPUC states that a minimum usage amount — to be provided free of charge — in the Commission's definition should be set equal to the minimum allowance included in measured service packages in California. This approach would allow the current measured services in California to meet the Commission's definition but would likely not meet the standards for other states.

Instead, GTE proposes that the Commission require that the universal service package be priced in such a way that the subscriber can purchase the service, including the required minimum amount of usage, for a price no higher than the "affordable" price established by the appropriate state commission for the given area. For example, if the state affordable rate level is \$20, then a flat-rate package priced at \$20 that included unlimited local calling would meet the definition. A measured package would also meet the definition if its monthly recurring charge were \$15, and if the minimum usage amount established by the Commission could be bought for no more than \$5 in additional usage charges.³⁴ This approach would meet the Commission's goal of ensuring that a minimum level of usage is available to consumers at a rate which is affordable. At the same time, it would allow carriers — including

(...Continued)

1433 (filed on computer diskette Aug. 15, 1997).

³⁴ A measured package with a minimum allowance at least as great as the required minimum usage would also meet the definition if the package price that included this allowance were no more than \$20.

wireless carriers — greater flexibility in devising packages with different pricing plans without requiring unlimited usage.

IV. GTE'S PROPOSED EMPIRICAL MODEL FOR ESTIMATING EXPENSES WILL PROVIDE EXPENSE INPUTS THAT REFLECT ACCURATELY THE COSTS OF PROVIDING UNIVERSAL SERVICES. (Section III.C.7)

In its Comments, GTE proposed that an empirical model be used to estimate expenses based on ARMIS data.³⁵ This type of approach which considers different geographic areas separately rather than using broad averages was supported by several commenters.³⁶ GTE's model will allow the Commission to estimate a specific set of expense factors for each ARMIS reporting area and will provide the Commission with an empirically supported means for adjusting expenses to be forward-looking.³⁷ The model also serves the dual purpose of accurately estimating companies' costs and establishing incentives for companies to be more efficient. Because the expense used in the model are based on estimated values, companies cannot collect additional support by increasing expenses.

GTE agrees with Bell Atlantic that use of investment-based expense factors, as in the Hatfield Model, could underestimate expenses to the extent that investments

³⁵ GTE Comments at 41-46.

³⁶ See, e.g., Aliant Comments at 7-8; Comments of the Florida Public Service Commission to Further Notice of Proposed Rulemaking Sections III.C.5, 7, 8 CC Docket Nos. 96-45, 97-160 at 2 (filed Oct. 16, 1997) ("Florida Commission Comments").

³⁷ GTE agrees with the Florida Public Service Commission that an ILEC should be able to use more disaggregated expense information if it can demonstrate that such disaggregation is necessary. Florida Commission Comments at 2.

themselves are underestimated by the model.³⁸ GTE's expense proposal avoids this problem by estimating expenses using ARMIS data. As GTE explained in its Comments, this approach is compatible with the expense algorithms used in BCPM.³⁹

In its comments, the Florida Public Service Commission suggests that marketing expenses should be excluded from the customer services expense estimates for universal service.⁴⁰ GTE disagrees. Basic local service is a retail product which requires marketing to customers.⁴¹ As the long distance market has shown, as competition increases, the marketing costs for each firm also increase. Therefore, in estimating the "forward-looking" expenses of LECs, the costs of marketing should be expected to increase from their current levels.

Excluding marketing expenses from the costs of basic local service is also inconsistent with the positions taken by most state commissions in interconnection proceedings. State commissions throughout the country have generally concluded that marketing expenses should be excluded from the "avoided cost" discounts for resale of ILEC services. If these expenses are "avoided" when the ILEC loses a customer, then they clearly are incurred when the ILEC retains customers. Therefore, in order for marketing expenses to be treated consistently, they should be included in the costs of universal service and counted as avoided costs for resale purposes.

³⁸ Bell Atlantic Comments at 6.

³⁹ GTE Comments at 41-46.

⁴⁰ Florida Commission Comments at 6.

⁴¹ See, e.g., Aliant Comments at 9.


V. CONCLUSION

The Telecommunications Act of 1996 requires that "[t]here should be specific, predictable and sufficient Federal and State mechanisms to preserve and advance universal service." In order to satisfy this mandate, the Commission must ensure that the input values and algorithms used in any cost model account accurately for the actual costs of providing basic local service. Throughout this proceeding, GTE has made recommendations which if implemented will help meet Congress's goal. Therefore, GTE urges the Commission to adopt GTE's proposals and use a cost model that ensures that ILECs will receive sufficient funding until a competitive bidding mechanism can be implemented.

Respectfully submitted,

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